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December 17, 2002

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station
Boston, Massachusetts 02110

Re: NSTAR Electric Company/NSTAR Gas Company, D.T.E. 02-78, Response of NSTAR to Comments of the Attorney General

Dear Secretary Cottrell:

On December 13, 2002, the Attorney General filed comments with the Department of Telecommunications and Energy (the "Department") concerning the November 27, 2002 request filed by Boston Edison Company, Cambridge Electric Light Company and Commonwealth Electric Company and NSTAR Gas Company (collectively "NSTAR" or the "Company") for an accounting ruling relating to pension and post-retirement benefits other than pensions ("PBOP"). NSTAR hereby files a response to the Attorney General.

In his comments, the Attorney General requests that the Department either deny the Company's request or allow for discovery and an evidentiary hearing to "fully examine the issues" prior to ruling on the request (Attorney General Comments at 1, 4). The Attorney General's recommendations are based solely on the claim that, under Department precedent, there is a "clear standard" that applies to the Company's requested accounting treatment and that, under this standard, the Company has "not demonstrated a prima facie case entitling it to a deferral" (id. at 2). As discussed below, the Attorney General's claim is flawed in that it misconstrues the nature and effect of the Company's request and rests on a misapplication of Department precedent.

As an initial matter, however, the Company would like to address the Attorney General's assertion that, although the denial of the Company's request could lead to detrimental financial consequences that may harm customers, the Department should deny the request or delay a ruling on the request because the Company has not shown that detrimental financial

consequences "will in fact result" from a denial of the request (id. at 4).[1] The Attorney General's standard would effectively place customers at a significant risk of incurring increased costs of capital in the future, without any potential benefits or protections to offset that risk. It is widely recognized by credit rating agencies that a reduction in book equity will result in a higher debt-to-capital ratio, which, in turn, has negative implications on a company's ratings, and ultimately, the cost of borrowings. Attached is a September 12, 2002 article by FitchRatings, which discusses the impact of pension accounting on a company's financial health. Consistent with the statements made therein, a $200-$300 million charge against equity will significantly weaken the Company's balance sheet and reduce common equity by approximately 20 percent. The Attorney General does not dispute this fact, but rather claims that this type of significant reduction will not result in detrimental financial consequences for the Company. The Attorney General's assertion has no basis in fact and misrepresents the historical impact of this type of change in a company's capital ratios.

The Company routinely confers with the rating agencies and possesses the experience and expertise to know that, in the absence of the accounting ruling, the Company's bond rating will be immediately called into question. As the Department is aware, the Company recently received approval and intends to issue long-term debt of up to $150 million for Commonwealth Electric Company. See, Commonwealth Electric Company, D.T.E. 02-51 (2002). The issuance of debt securities in the face of an impaired debt-to-equity ratio, will inevitably result in the debt being issued at a higher cost than without the equity charge. Moreover, the Company routinely relies on significant short-term debt instruments to fund day-to-day operations. These transactions will also be more costly as a result of the changed equity status of the Company. Therefore, denial of the accounting ruling has the potential to dramatically increase the Company's cost of capital and to increase the cost of service borne by customers. Thus, the Attorney General's argument that denial of the accounting ruling will have no negative impact on the Company or its customers is unfounded and erroneous and should be rejected by the Department.

In fact, because no change in rates would be instituted upon the Department's approval of the Company's request, customers can only be harmed by the denial or delay in the approval of the request. The Department's approval of the accounting treatment requested by the Company would preclude the unavoidable year-end accounting adjustments required of the Company, and therefore, eliminate entirely the potential for any detrimental financial consequences that would result in harm to customers. At the same time, as acknowledged in the Company's request, the Department's approval would leave open the underlying issues

[1] In this case, a delay by the Department in ruling on the request to allow for discovery and an evidentiary hearing is tantamount to a denial since the accounting entries must be made as of December 31, 2002.

relating to the specific ratemaking methodology that would be used to recover pension and PBOP-related costs in the future. Therefore, as stated above, a decision by the Department to grant the accounting treatment would protect customers from the detrimental effects of the year-end accounting requirements, while preserving the Attorney General's ability to participate on behalf of customers in a future proceeding to establish the specifics of the cost-recovery mechanism before any change in rates is implemented.[2] Because customers have significant exposure if the request is denied or delayed, the Department should reject the Attorney General's request to deny or delay the request on the basis that the financial impact of a charge to equity of this magnitude cannot be precisely quantified.

In addition to understating the seriousness of the detrimental financial consequences that would result from a write-off, the Attorney General has applied a standard of review that is inapplicable to the Company's request. As discussed in detail below, the issues driving the Company's request are a function of unprecedented economic circumstances coupled with the constraints of the financial accounting and ratemaking processes, which have not previously been considered by the Department. As a result, the Attorney General's attempt to assert that any and all requests for accounting treatment coming before the Department are subject to the existing Department precedent, is misguided and should be rejected by the Department.

1. The Attorney General's Comments Misconstrue the Company's Request and Misapply Department Precedent.

The Attorney General's recommendation that the Company's request should be denied or delayed is predicated on the erroneous assumption that an accounting deferral that temporarily creates a regulatory asset must be limited to circumstances in which a company has incurred an extraordinary cost that would trigger a rate case in the absence of the Department's approval of the deferral.

However, it should first be noted that the Department issues accounting rulings pursuant to its general supervisory and ratemaking authority under G.L. c. 164, §§ 76 and 94. The issuance of an accounting ruling is not prescribed or constrained by statute or regulation either in relation to the process that is required to evaluate a request for an accounting ruling or the standard of review to be applied by the Department in evaluating such requests. To be sure, the majority of requests for accounting deferrals have involved the deferral of extraordinary

[2] Such a proceeding would necessarily involve discovery and evidentiary hearings as requested by the Attorney General.

expenses in a cost category included in base rates.[3] In the case cited by the Attorney General, North Attleboro Gas Company, D.P.U. 93-229 (1994), the Department explicitly stated that it was clarifying its standard for the review of requested deferral accounting treatment for "extraordinary pretest year expenses." D.P.U. 93-229, at 7 (emphasis added). Thus, the Department's statements in D.P.U. 93-229 do not address the circumstances where a company may be seeking an accounting treatment for something other than the recovery of an extraordinary pre-test year expense. Significantly, NSTAR's request for a deferral is not based on the existence of an extraordinary pre-test year expense, and therefore, the Attorney General's arguments (and cited precedent) do not apply.

In this case, the driving factor underlying the Company's request for an accounting treatment is the existence of an unfunded liability in the pension trust combined with the existence of a sizeable prepaid asset account balance, which has resulted from the Company's longstanding practice of making cash contributions to the fund in excess of the annual expense booked in accordance with FAS 87 and FAS 106. Specifically, the Company estimates that, by December 31, 2002, the assets in the NSTAR trust funds will be reduced to approximately $650 million and liabilities will be equal to approximately $825 million as a result of equity-market declines and changes in interest/discount rates, representing an unfunded liability of approximately $175 million.

As noted in the Company's request for an accounting ruling, this shortfall creates accounting issues for the Company that will have a significant negative impact on the financial health of NSTAR and the cost of capital used to fund utility operations on behalf of the Company's gas and electric customers. Specifically, FAS 87 requires that tax-deductible pension contributions in excess of the annual expense derived under FAS 87, are to be recorded as a asset (i.e., prepaid pension expense) on the Company's books. As of December 31, 2002, NSTAR will have a prepaid pension balance of approximately $252 million resulting from the significant tax-deductible contributions made over the past several years in excess of the expense recorded on the Company's books under FAS 87. These contributions were made in accordance with the policy directives of the Department.

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[3] The genesis of many requests for accounting deferrals was the Department's order in Commonwealth Electric Company, D.P.U. 88-135/151, at 21-30 (1989) in which the Department denied recovery of pre-test year extraordinary storm expenses. Thereafter, it was clear that, absent an accounting ruling, if a company incurred a large expense for a cost category included in base rates, the expense could be recovered only if the year in which the expense was incurred was a test year. The Commonwealth case did not affect the deferral and recovery of cost categories subject to reconciliation mechanisms, e.g., fuel charge, cost of gas adjustment clauses, transition costs, environmental remediation costs.

Under FAS 87, this prepaid asset must be written off the Company's books as of December 31, 2002 because a portion of the Company's pension obligation is now unfunded. Since the amount of the Company's pension obligation will exceed the value of the fund assets as of December 31, 2002, the Company must also recognize an "Additional Minimum Liability" equal to the difference between the pension obligation and the value of the fund assets. The "Additional Minimum Liability" must be added to the balance of the prepaid asset account and the sum total would be recorded on the Company's books as a charge to common equity.[4] This charge to common equity will have the direct effect of reducing the Company's common equity on the balance sheet by $260 million (net of taxes), which represents a 20 percent reduction in the common equity of the Company.

In this case, the Company is asking the Department to allow the Company to defer, and record as a regulatory asset the amount of its current and future Additional Minimum Liability, which represents the "unfunded" pension obligation. The Additional Minimum Liability does not represent a not a single-year expense that would be included as a test-year expense in a rate case filing. The balance of the asset account will change as the asset value of the trust fund is affected by market conditions. Accordingly, the Company's request here is not the same as those deferral cases, like North Attleboro, that were designed to address the pre-test-year extraordinary expense disallowances that were raised by the Commonwealth case.

The Attorney General cites to Fitchburg Gas and Electric Light Company, D.T.E. 02-24/-2-25 (2002) in support of the claim that "neither the booked expense amount, nor the Additional Minimum Liability are recoverable under Department precedent" (Attorney General Comments at 2), and therefore, do not qualify for deferral treatment. However, the Attorney General is confusing the issue of the requested accounting treatment with the issue of the precise mechanism of how pension and PBOP costs are recovered through rates, which will not be determined as a result of the Department's approval of the Company's requested accounting ruling.

For example, there is no question that, prudently incurred expenditures made by regulated companies for pensions and PBOPs are recoverable in rates because such costs are incurred in order to provide service to customers. Under basic cost-of service ratemaking principles, rates are set to recover a representative level of the costs that are needed to serve customers. Thus, the challenge for the Department in setting rates to recover pension and

[4] In effect, these provisions of FAS 87 are designed to recognize that the Company's investment in the pension fund has been deteriorated by equity losses in the market. However, were the Department to allow the Company to defer the prepaid balance as a regulatory asset, as described below, the Company's investment would be effectively maintained until such time that additional cash contributions and market gains would mitigate the discrepancy between the value of assets held in the trust funds and the pension obligations.

PBOP costs has been in identifying the representative level of costs to be included in rates.[5] As noted in the Fitchburg decision, the Department has generally set rates to recover an average of annual cash contributions made by a company to its pension and PBOP trust funds. D.T.E. 02-24/02-25, at 110. Therefore, where a company is able to demonstrate that it makes annual contributions to its pension and PBOP funds, the Department has typically included the average of the annual contributions in rates. Boston Gas Company, D.P.U. 93-60, at 234-235 (1993). At the same time, however, the Department has expressly refrained from establishing a set policy on the calculation of pension costs for ratemaking purposes and has consistently maintained that the intricacies of the issue warrant an investigation on a case-by-case basis. Boston Gas Company, D.P.U. 96-50, at 81 (Phase I) (1996), citing, D.P.U. 95-118, at 111; D.P.U. 95-40, at 44; D.P.U. 92-78, at 46. Therefore, the Department's historical practice of including cash contributions in rates does not mean that cash contributions are recoverable and booked expenses or the Additional Minimum Liability are not. It means only that the Department has, in the past, selected cash contributions rather than booked expenses as representative of the Company's annual pension cost in setting rates.

In any event, the accounting ruling that the Company seeks here would not predetermine the characteristics of the mechanism used to determine the amount of pension and PBOP costs that would be included in rates. The accounting ruling is intended only to avoid the adverse consequences that will otherwise result from a series of unprecedented market conditions that have created a temporary accounting deficiency in its pension fund, despite the aggressive funding policies of the Company. The creation of a regulatory asset as requested, will not limit the Department's right to review (nor the Attorney General's right to challenge) the prudence or reasonableness of expenditures or the precise way in which prudently incurred pension and PBOP costs are recovered from customers.[6] This is entirely consistent with the Department's long-held approach to the calculation of pension costs for ratemaking purposes, which allows for an investigation of the appropriate level of costs to be included in rates on a

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[5] This will be especially true given the current circumstances because the disparities between the FAS 87 and FAS 106 requirements for determining annual pension and PBOP expenses and the tax rules associated with the deductibility of cash contributions will be exaggerated over the next few years in light of the significant swings in the fund value that have occurred and may continue to occur as economic conditions fluctuate.

[6] As the Attorney General points out, "the Company may elect to file a rate case as early as March of 2003 for effect after the expiration of the four year merger 'rate freeze' period" (Attorney General Comments at 2). Until that time, the rates charged to customers cannot be changed, nor will a ruling on the request for accounting treatment have the effect of making such a change. Thus, the Attorney General will have ample opportunity to address his ratemaking issues.

case-by-case basis in the context of a base-rate proceeding.[7] Moreover, the Company is not seeking any change in rates through this request, and any future rate change can be accomplished only with Department approval after full review and opportunity for hearing in a rate proceeding. Therefore, despite the Attorney General's assertions, the Company's proposal comports with Department practice and precedent, and in no way contradicts the Department's findings in the Fitchburg case, or any other rate proceeding conducted by the Department.

2. The Attorney General's "Reasons" for Denial Are Without Merit.

The Attorney General lists six reasons for the Department either to deny the request or to conduct an investigation prior to the issuance of the ruling (Attorney General Comments at 3-4). Although each of these is generally based on the mischaracterization of the request and misapplication of precedent as discussed above, in the interests of completeness and clarity, the Company will briefly address each issue separately.

> *"(1) The Company has not established that the "true-up" amount is an extraordinary operating expense that Department precedent would allow as proper for deferral, Boston Gas Company, D.P.U. 89-177, pp. 7-8 (1989), or that the costs are recoverable from customers in a subsequent rate case"* (Attorney General Comments at 3).

As discussed above, the nature of the Company's request is not one in which the Company is seeking to defer extraordinary pre-test year costs, and therefore, the precedent cited by the Attorney General is not controlling in this case. However, it is well established that pension and PBOP costs are recoverable from customers in rates. Given the unique economic circumstances affecting the Company's pension fund obligations and liabilities, the Company anticipates that cash contributions, booked expenses and the prepaid asset account will exhibit an unprecedented level of variability over the next several years. The Company's request is intended to preclude the detrimental financial impacts that would be associated with a significant common equity charge and to allow an opportunity for the Department to consider the ratemaking methodology that will be used to identify the appropriate level of costs to be included in rates. Although the Department's approval of the requested accounting treatment

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[7] The Company is seeking to defer the difference between the level of pension and PBOP expenses included in rates and the amounts that must be booked in accordance with FAS 87 and FAS 106, as well as the amount of the Additional Minimum Liability, because Generally Accepted Accounting Principles ("GAAP") require the Company to book pension and PBOP obligations in a certain manner in order to qualify as a regulatory asset. However, this treatment does not dictate the structure of the ratemaking mechanism that the Department may adopt in a future proceeding to provide for the recovery of pension-related costs.

may have the collateral effect of delaying or eliminating the filing of one or more rate cases,[8] the Company's request is not predicated on that basis.

> *"(2) The Company has not established the level of pension and PBOP expenses in the Company's rates. The relevant rates of the distribution companies were fixed by settlement or rate cases that are as much as ten years old* [footnote omitted] *Several of the NSTAR companies rates were set in settlements; in the settled rate cases there are no Department findings on the specific dollar amounts of individual costs, including pension and PBOPs"* (Attorney General Comments at 3).

The Attorney General is correct that determining the precise level of pension and PBOP expenses that are currently in the Company's rates is complicated by rate settlements as well as industry restructuring and generation asset divestiture. However, the deferral request is based on the accounting deficiencies and expenses that must be reported under GAAP, and the amount that has been or will be included in rates is a separate ratemaking issue that will be determined by the Department in a rate proceeding. The Company is not requesting such a ruling by the Department at this juncture, nor is it necessary for the Department to make a finding with regard to this issue.

> *"(3) The Company has not established that the pension and PBOP expenses cannot be changed from year to year simply by making minor changes in actuarial assumptions, thus directly affecting the regulatory asset balance"* (Attorney General Comments at 3).

Again, the Attorney General is raising an issue that is totally irrelevant to the request. To the extent that the actuarial assumption underlying the calculation of pension and PBOP expenses are subject to question at all, it would be only in the context of a ratemaking proceeding where the Department would be considering the appropriate level of costs to put into rates. In that regard, the Department has recognized that the calculation of pension and PBOP expenses for accounting purposes is dictated by FAS 87 and FAS 106, respectively. Western Massachusetts Electric, D.P.U. 87-260, at 44 (1988). The Department has further recognized that the adoption of FASB 87 and 106 made pension plan expense calculations less flexible. Id. Therefore, to the extent that the annual level of pension and PBOP expense is determined by actuarial assumptions regarding items such as future health care costs, mortality of employees and discount rates, the Company relies on independent, professional actuaries

[8] As noted above, because of the Company now faces an unfunded obligation, the Company's cash contributions in 2003 and beyond will significantly exceed the expense level currently in distribution rates. Accordingly, denial of the requested accounting ruling will greatly increase the possibility that all four companies will need to seek rate relief next year.

who prepare a report for the Company on an annual basis. This analysis is subject to review by the Company's outside auditors and, consistent with GAAP is based on various external indices and accounting conventions. Accordingly, the Attorney General claims in this regard should be rejected by the Department.

> *"(4) The Company has not established that any of the individual distribution companies will experience severe detrimental financial effects without the proposed deferral. In fact, NSTAR reported to the financial community an estimated $200 – $300 million impact of this accounting at end of the third quarter, yet the Company's bond rating has not changed, and the evidence does not show that the Company is having difficulty attracting capital. This transaction is not a cash outlay, rather it is an accounting accrual apparently recorded by the holding company"* (Attorney General Comments at 3-4).

In its most recent Form 10-Q filed with the Securities and Exchange Commission on November 27, 2002, NSTAR made the following statements in relation to the potential equity write-off:

> Assuming there is no significant change in interest rates or equity market performance for the remainder of the year, NSTAR anticipates that the after-tax charge to OCI will be approximately $200 million to $300 million
>
> ***
>
> NSTAR anticipates filing a request with the [Department] seeking an order to mitigate the non-cash charge to OCI and the increases in expected pension and other postretirement benefit costs and cash contributions. If approved, this request could potentially allow NSTAR to record a regulatory asset in lieu of a charge to OCI.

(Form 10-Q, at 9-10).

The fact that the financial markets have not yet reacted to the Company's indications on the pension-fund situation is not surprising, nor does it represent a signal that financial repercussions will not occur once the write-off is certain. The Company is under an obligation to disclose that a write-off may take place, but ratings agencies typically do not take definitive action until the event has actually occurred, especially where the Company has indicated that a resolution is being pursued through the regulatory arena. As a result, the fact that the

Company's ratings have not yet been downgraded is not indicative of the consequences that will take place if the charge to common equity occurs.

> *"(5) The Company has not established the actual amount of the deferral and references stale data. The Company accounted for its pension and PBOPs trust fund assets for the most recently reported quarter, September 30, 2002. Since that time the stock market has risen 18 percent. The Company has failed to indicate what the expected deferral amount will be by December 31, 2002"* (Attorney General Comments at 4).

First, it should be noted that the Company's request would apply to the balance of the prepaid account as of December 31, 2002, as calculated using the most recent data available to the Company. Moreover, although the precise, final amount of the deferral cannot be known until after December 31, 2002, the change in the stock market is only one factor in the equation and, in fact, the recent rise in the stock market has had only a small impact on the overall position of the pension fund. Extremely low interest rates have also increased the Company's pension liabilities and these rates remain relatively unchanged. Taking account of the asset position as of the closing of the stock market on December 13, 2002, the charge against equity on December 31, 2002 is currently projected to be $253 million.

> *"(6) The Company indicated that this accounting problem is for the year 2002 and the situation will reverse in 2003. The Company, however, has not indicated what the Department should do if the situation reverses itself in 2003"* (Attorney General Comments at 4).

The Attorney General has misstated the Company's position with respect to the "reversal" of the accounting entries that, absent a favorable Department ruling, will occur as of December 31, 2002. Certainly, the economic conditions over the past several years that have precipitated the accounting deficiency are unprecedented and there is every expectation that, over time, more favorable market conditions will improve the performance of the pension and PBOP trust funds. The long-term funding of pensions and PBOPs that will eventually be collected from customers will fully benefit from improved market performance, but there is nothing that will reverse the immediate harm to the Company and its customers, absent Department approval of the accounting ruling. Moreover, it is the Company's intent to establish a mechanism that ensures that customers get the benefit of any reduction in costs associated with improved market performance in the future.

?? **Conclusion**

For the reasons described above, the Attorney General's objections to NSTAR's request have no basis in fact or law. The request is narrowly framed to solve the immediate and potentially devastating financial accounting problem that has resulted from the convergence of a series of market events that are totally outside of the control of NSTAR. Approval of the request results in no adverse impacts to NSTAR customers, but avoids the serious negative effect of accounting conventions. Accordingly, the Department should dismiss the Attorney General's comments and approve the requested accounting ruling.

Thank you for your attention to this matter.

Sincerely,

Robert J. Keegan

cc: Caroline O'Brien, Hearing Officer (seven copies)
Paul G. Afonso, General Counsel
Joseph Rogers, Assistant Attorney General
Service List

Enclosure